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Regional Technical Coordinator
Midwest Region

Assistant Chief Counsel (Income Tax & Accounting)
National Office TCR 17,906--TR-45-1157-91

Technical Coordination Report Submitted by:
George Hertz
Des Moines District

Recommending: Issuance of a revenue ruling concerning
"dividend" payments of special purpose
funding corporation.

In his report, Mr. Hertz recommended that we issue a revenue ruling holding that "dividend" payments made by a special purpose funding corporation subsidiary of a savings and loan association are payments of interest that do not qualify for the dividend received deduction under section 243 of the Code. In the case cited by Mr. Hertz, the financial institution had large and presumably unusable net operating losses. Accordingly, it made no difference from a tax standpoint to the financial institution whether the payments were characterized as dividends on preferred stock rather than interest. However, by offering corporate investors a deduction under section 243, the financial institution was able to effectively lower its borrowing costs. Mr. Hertz's extensive research indicated that regulatory agencies treat the security in question as debt and the payments as interest.

The characterization of these and similar security issuances as debt or equity has been a troubling issue. See, e.g., Rev. Rul. 90-27, 90-1 C.B. 50 (certain "dutch-auction-rate preferred stock" characterized as equity for purposes of section 243 of the Code). In 1987, the House version of the Omnibus Budget Reconciliation Act of 1987 would have disqualified stock with "nonstock characteristics" from the deduction under section 243. H. R. 3545, 100th Cong. 1st Sess. § 10132. Such "nonstock characteristics" were defined to include any stock which in substance (through mechanism, arrangement, or otherwise) has an enhanced likelihood that the principal, dividends, or both, will be received. According to the committee report, the bill would have affected:

[S]tock issued by a corporation where a major part of the value of that corporation consists of notes or other instruments giving or attempting to give that

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corporation a priority interest or preference in the assets or income of another entity. Similarly, the bill affects arrangements in which a so-called "special purpose subsidiary" issues stock (whether or not it is non-voting preferred stock) and the holder of the stock is effectively insulated from liabilities of the parent corporation by virtue of the fact that the subsidiary's assets are relatively secure, while the parent corporation enjoys a portion of the return on the funds provided by the "special purpose subsidiary" investors.

H.R. Rep. No. 100-391, 100th Cong. 1st Sess. 1095 (1987).

This provision was not included in the legislation as enacted. This lends some support to the argument that the type of security referred to in the House bill and Mr. Hertz's report is an equity investment under current law. Another factor to consider is the effect that debt characterization of these securities might have on the Service's position in other cases in which the Service seeks to characterize investments as equity.

In view of the importance of this topic, we are referring Mr. Hertz's report to the Office of the Assistant Chief Counsel (Financial Institutions and Products), which is currently considering this matter. If the District Office has a case pending on this issue, you may wish to consider a request for technical advice.

We appreciate the interest Mr. Hertz has taken in this matter and hope that he will continue to submit his ideas. Copies of this memorandum are enclosed for Mr. Hertz and other interested persons.

Assistant Chief Counsel
(Income Tax and Accounting)

By (signed) Michael D. Finley
Michael D. Finley
Chief, Branch 3

Attachments: (4)